Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

NYNEX CORPORATION, *et al.*,
Petitioners,

v.

DISCON, INCORPORATED,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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SUPPLEMENTAL BRIEF FOR PETITIONERS

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SUPPLEMENTAL RULE 29.6 STATEMENT

Since the filing of the Rule 29.6 Statement in the Petition (at ii-iii), petitioner NYNEX Corporation has become a subsidiary of Bell Atlantic Corporation.

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SUPPLEMENTAL BRIEF FOR PETITIONERS

Just as the Second Circuit made up its own theories to replace Discon's, the Government has now refused to defend the stated grounds of decision below and instead, defending the judgment in part, advanced its own new theories. These new theories only heighten the need for review, for they are unprecedented, incorrect, and dangerous (as well as inevitably influential). In conflict with numerous precedents, they blur the critical line between horizontal and vertical agreements, seek to relax the burdens of challenging purely vertical nonprice agreements, and boldly propose extending antitrust law to mere regulatory problems (overcharging consumers), where no *competition* issue is present. As the leading treatise notes, this is a case of alleged regulatory fraud masquerading as an antitrust case. P. Areeda & H. Hovenkamp, *Antitrust Law* ¶ 1644'c, at 726-28 (Supp. 1997). Review is imperative to resolve the conflicts and to prevent the inevitable chill on efficient changes of suppliers caused by imposing increased litigation risks and costs even where, as here, there cannot be any proof of harm to competition.

Section 1 Conspiracy. 1. The Government agrees that the Second Circuit was wrong in expressly countenancing "group boycott" and *per se* standards for judging what is no more than a two-firm vertical nonprice agreement. SG Br. 12, 14-15. Though peculiarly reluctant to state clear standards directly, the Government does not dispute that only horizontal agreements can be "group boycotts," as numerous Circuits recognize (Pet. 9-10), and that this Court repeatedly has held that a nonprice vertical agreement is not subject to a *per se* standard but to ordinary rule-of-reason analysis. *State Oil Co. v. Khan*, 118 S. Ct. 275, 281 (1997); *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988); *Continental TV, Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977); U.S. Br. 15, *State Oil v. Khan* (under *Sylvania* "vertical non-price restraints should be judged under the rule of reason"). The Second Circuit's sole basis for reinstating Discon's Section 1 claim—that Discon may challenge the two-firm nonprice vertical agreement on a group boycott theory

and that, upon proof of some set of facts alleged in the Amended Complaint, this theory may give rise to *per se* liability—thus conflicts with decisions of this Court and other courts. The ruling should be reviewed and readily reversed, for the Government has advanced no sound reason for allowing this erroneous and harmful ruling nevertheless to stand.

2. The Government makes two procedural points, but neither supports denial of review. First, while " '[t]his Court reviews judgments, not statements in opinions' " (SG Br. 12), that principle applies only to dicta; it is not properly invoked to disregard a lower court's sole stated rationale, which sets binding precedent for the Circuit.[1] This Court routinely reviews a lower court's stated rationale and remands for consideration of other possible grounds, as it just did in *State Oil Co. v. Khan*. *See Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46 (1990) (summary reversal in antitrust case); *cf. Trest v. Cain*, 118 S. Ct. 478 (1997) (reversing court's adoption of grounds not argued by parties). Second, while this case comes to the Court from a reversal of an order dismissing a (detailed Amended) Complaint (SG Br. 7, 18-19), this Court has heard many antitrust cases in this posture.[2] Here, as in those cases, the precedential ruling on the legal adequacy of the facts alleged demands review because of its importance and inconsistency with other decisions. And unalleged facts are irrelevant: on a motion to dismiss, "[i]t is not . . . proper to assume that the

[1] *See Seminole Tribe of Florida v. Florida*, 116 S. Ct. 1114, 1129 (1996); *United States v. Ianniello*, 808 F.2d 184, 190 (2d Cir. 1986), *cert. denied*, 483 U.S. 1006 (1987).

[2] *E.g., Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993); *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322 (1991); *Hoover v. Ronwin*, 466 U.S. 558 (1984); *Associated General Contractors v. California State Council of Carpenters*, 459 U.S. 519 (1983); *Blue Shield of Virginia v. McCready*, 457 U.S. 465 (1982); *St. Paul Fire & Marine Ins. Co. v. Barry*, 438 U.S. 531 (1978); *City of Lafayette v. Louisiana Power & Light Co.*, 435 U.S. 389 (1978); *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186 (1974).

[plaintiff] can prove facts that it has not alleged or that the defendant has violated the antitrust laws in ways that have not been alleged." *Associated General Contractors*, 459 U.S. at 526.

3. The Government also urges denial of review based on its own effort to reformulate the Second Circuit's rationale. SG Br. 12-17. But no such recharacterization can erase the clear holding, confirmed by the express rejection of other Circuits' contrary views (Pet. App. 11a-12a), that *per se* condemnation is available for some vertical nonprice arrangements. *See Electronics Communications Corp. v. Toshiba America Consumer Prods., Inc.*, 129 F.3d 240, 244 (2d Cir. 1997) (*Discon* holds "that an agreement between a supplier and its purchaser that disadvantaged the supplier's competitor could constitute a violation of the antitrust laws, even a per se violation"); P. Areeda & H. Hovenkamp, *supra*, at 726, 727 (recognizing *per se* holding here). In any event, the Government's reformulation does not weaken the grounds for review.

Under the Government's version, a firm may incur antitrust liability and treble damages for its choice of supplier, even if no harm to competition is proven (mere allegations will suffice), unless the firm produces a "valid procompetitive justification." SG Br. 12-13, 16-17. But this formulation itself violates black-letter law requiring proof of anticompetitive effects to impose rule-of-reason liability for vertical nonprice agreements: "The plaintiff bears the burden of proving that a restraint has a substantial anticompetitive effect. Absent such an anticompetitive effect, the defendant need not proffer justifications for its conduct." ABA Section of Antitrust Law, *Antitrust Law Developments* 55 (4th ed. 1997) (footnotes citing decisions omitted). This bedrock principle protects free-market choices against the litigation costs and risks imposed by forcing businesses to justify their choices to government enforcers and courts in the absence of present or threatened market power.[3]

[3] To distinguish harm to competition from harm to competitors, the anticompetitive effects element of a rule-of-reason case requires

No precedent supports departing from this fundamental rule-of-reason standard for vertical nonprice agreements. The Government relies entirely on two decisions that suggest (without resting on) a truncated inquiry into market power in a narrow class of cases involving "naked" restrictions on competition between rivals, *i.e.*, collusive horizontal agreements, which might otherwise be illegal *per se*. *See* SG Br. 16 (citing *FTC v. Indiana Federation of Dentists*, 476 U.S. 447 (1986), and *NCAA v. Board of Regents*, 468 U.S. 85 (1984)). But since *GTE Sylvania*, no such approach has been or could be applied to vertical nonprice agreements. *See U.S. Healthcare, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 594-95 (1st Cir. 1993). Remarkably, the Government does not acknowledge that its reading of the Second Circuit opinion proposes for the first time to extend a burden-shifting "quick look" approach across the horizontal-vertical line. Nor does it explain how blurring that line could be squared with this Court's insistence on maintaining the line with clarity to preserve firms' freedom to choose suppliers and make other vertical agreements. *See Sharp*, 485 U.S. at 726, 730 & n.4.

The regulated monopoly setting provides less, not more, justification for weakening rule-of-reason requirements for challenging purchaser-supplier contracts. Regulated companies (or, more generally, businesses operating under cost-plus contracts) need freedom to change suppliers, or to enter into requirements contracts, at least as much as other companies.[4] Moreover, with regulators monitoring

proof of actual or threatened market power. *See SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F.3d 958, 965-66 (10th Cir. 1994), *cert. denied*, 115 S. Ct. 2600 (1995); *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 229 n.11, 230 (D.C. Cir. 1986) (Bork, J.), *cert. denied*, 479 U.S. 1033 (1987); *Ball Memorial Hospital, Inc. v. Mutual Hospital Ins., Inc.*, 784 F.2d 1325, 1334-35 (7th Cir. 1986) (Easterbrook, J.).

[4] The government itself recognizes that, though "considered to enhance efficiency," "[v]irtually any requirements contract could be characterized as a 'two-firm vertical' agreement 'to discriminate in favor of one supplier over another' " and thus fall under the shadow of the Second Circuit's ruling. SG Br. 14 n.11 (quoting Pet. App. 12a).

the very sort of conduct alleged in the Amended Complaint (*see* Pet. App. 5a; SG Br. 3 n.2), the "need" for antitrust scrutiny is smaller. At the same time, under Discon's premise of pass-through of excess costs to captive ratepayers, the increased costs caused by the chilling of supplier changes are less easily avoided by downstream consumers. It is perverse to deter efficient input choices precisely where the adverse impact on consumers may be least escapable.

4. The Government's primary argument against review here is a brand new rule-of-reason theory. SG Br. 7-12. Such an alternative defense of the judgment does not justify disregard of the lower court's actual rationale. In any event, the Government's theory fails on its merits. No rule-of-reason standard can be met in this case, because no factfinder could reasonably find harm to " '*competition*, not *competitors*' " (*Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 224 (1993)) in the market actually alleged—removal services bought by NYNEX, *not* telephone service sold by NYNEX.[5] The Government's radical new antitrust theory, deeming mere overcharges in the regulated telephone-service market legally sufficient, strongly magnifies the need for review.

The Government asserts: "[a]n agreement between a regulated monopolist and its supplier to exclude a competing supplier from the market, when that agreement has the purpose and effect of enabling the monopolist to evade regulatory scrutiny and exercise market power in a downstream market, violates Section 1 in the absence of

[5] Discon avoided alleging any restraint on competition in the telephone-service market, because this case has nothing to do with any rivalry between sellers of telephone service; the only market in which competition is alleged to be restrained is a market in which NYNEX was a buyer. Amended Complaint ¶ 3 (alleged combination is "to restrain trade in the *market for removal services* and other products and services *purchased by* telephone companies") (emphasis added), ¶ 59 (same), ¶ 110 ("to restrict competition in the *market for removal services* at [New York Telephone] and in the New York State area") (emphasis added).

any procompetitive justification." SG Br. 12. This standard boldly dispenses with any requirement of harm to competition in the market from which the competing supplier was allegedly excluded—here, the removal-services market. The Government, only briefly mentioning that market (SG Br. 9), thus tacitly concedes that no such requirement could be met here. The Government does not dispute that NYNEX did nothing to "exclude" Discon beyond favoring AT&T as a supplier. *See* Pet. 14 & n.6. No harm to competition (rather than competitors) could result unless the new supplier could obtain market power and then maintain it by keeping out lower cost rivals wishing to serve other buyers seeking the services. *See* note 3, *supra*; note 9, *infra*. Yet, buried in a footnote (SG Br. 9 n.8), the Government concedes that nothing is alleged about the role of other competitors, harm to other purchasers, or the existence of entry barries for this business (consisting of dismantling and disposing of telephone central office equipment). Moreover, any allegation of market-wide harm would be "inherently implausible," even "preposterous," for a reason explained by the Seventh Circuit in upholding dismissal of a complaint in *Car Carriers, Inc. v. Ford Motor Co.*, 745 F.2d 1101, 1109, 1110 (7th Cir. 1984), *cert. denied*, 470 U.S. 1054 (1985): it makes no economic sense to say that NYNEX, the principal *buyer* in the market, was conferring power on AT&T, its supplier, to exploit NYNEX itself through excessive prices and curtailed output, especially when, under Discon's own theory, NYNEX had no incentive to limit removal services. Lacking necessary allegations and resting on an implausible theory, this suit should be dismissed to prevent misuse of Section 1 to erode firms' essential freedom to select suppliers. *See Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 594 (1986); *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 763 (1984).

Unable to identify relevant harm in the alleged market, the Government's regulatory-evasion theory rests entirely on alleged harm to consumers in the market for telephone service, even though this case contains no alleged restraint of competition in that market. The Government relies on

the assertions that "[a]n increase in consumer prices resulting from the exercise of market power is an anticompetitive effect" (SG Br. 8; *see id.* at 9 n.6 ("[t]he anticompetitive effect . . . is the *exercise* of market power")) and that Section 1 reaches "the exercise of market power . . . in a market different from the one in which the restraint was imposed" (*id.* at 9). But these claims are an insupportable and radical effort to extend antitrust law, which is concerned only with consumer harms brought about *through impairment of competition*, to other forms of alleged consumer exploitation (*e.g.*, fraud, regulatory evasion) that have noting to do with the hobbling of competitors, let alone competition.[6]

No support for the Government's theory can be found in its only cited authority, *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984). Neither the majority nor the concurrence says that the exercise of lawfully possessed market power is "anticompetitive" absent impairment of rivals' opportunities to compete in the market allegedly restrained, and the case unmistakably involved alleged consumer harm *through impaired competition* (for anesthesiology services and for doctor-hospital affiliations).[7] Nor can the Government justify the dramatic results of its novel theory: any change of supplier by a regulated monopolist (or any cost-plus business), at least any change to a superficially more costly supplier, could give rise to a Section 1 claim by the displaced supplier,

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[6] *See Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 22 (1st Cir. 1990), *cert. denied*, 499 U.S. 931 (1991) (antitrust, unlike direct regulation, addresses only the competitive *process*); S. Breyer, *Regulation and Its Reform* 156-57 (1982) ("the antitrust laws differ from classical regulation both in their aims and in their methods"; antitrust laws "seek to create or maintain the *conditions* of a competitive marketplace rather than replicate the *results* of competition or correct for the defects of competitive markets").

[7] The Government's unfounded use of *Jefferson Parish* as a springboard for new liability without impairment of competition highlights the concerns behind Justice O'Connor's concurrence urging the adoption of a rule-of-reason standard for tying claims, including the requirement of a substantial threat of "market power in the tied-product market." 466 U.S. at 38.

requiring costly litigation over intent and effect. Efficient changes of supplier would be deterred, and antitrust courts would be embroiled in regulatory accounting and pricing issues in unfamiliar, unnecessary, and inappropriate ways. *Cf. Town of Concord*, 915 F.2d at 25-29.

Not just unsupported, the Government's theory conflicts with the decisions of numerous courts, including the Second Circuit, concluding that the *exercise* of market power is *not* anticompetitive. *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 294 (2d Cir. 1979) ("setting a high price may be a use of monopoly power, but *it is not in itself anticompetitive*") (emphasis added), *cert. denied*, 444 U.S. 1093 (1980).[8] Overcharging consumers by exercising market power may present a regulatory problem, but it is not an antitrust problem absent impairment of rivals' opportunities. To the contrary, "the charging of a high price is, so far as potential competitors are concerned, an attracting rather than an excluding practice." *Marshfield Clinic*, 65 F.3d at 1413; *see Berkey*, 603 F.2d at 294.

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[8] *See Alaska Airlines, Inc. v. United Airlines, Inc.*, 948 F.2d 536, 548-49 (9th Cir. 1991) (same), *cert. denied*, 503 U.S. 977 (1992); *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*, 65 F.3d 1406, 1412-13 (7th Cir. 1995) (Posner, C.J.) ("[T]he antitrust laws do not regulate the prices of natural monopolists. A natural monopolist that acquired and maintained its monopoly without excluding competitors by improper means . . . can therefore charge any price that it wants, for the antitrust laws are not a price-control statute or a public-utility or common-carrier rate-regulation statute.") (citations omitted), *cert. denied*, 116 S. Ct. 1288 (1996); *Williamsburg Wax Museum, Inc. v. Historic Figures, Inc.*, 810 F.2d 243, 252 (D.C. Cir. 1987) ("imposition of a high price is not, in and of itself, an anticompetitive act"); *Kartell v. Blue Shield of Mass., Inc.*, 749 F.2d 922, 927 (1st Cir. 1984) (Breyer, J.) ("Ordinarily, however, even a monopolist is free to exploit whatever market power it may possess when that exploitation takes the form of charging uncompetitive prices."), *cert. denied*, 471 U.S. 1029 (1985); *Trace X Chem., Inc. v. Canadian Indus., Ltd.*, 738 F.2d 261, 267-68 (8th Cir. 1984) ("[S]etting a high price is not in itself anti-competitive."), *cert. denied*, 469 U.S. 1160 (1985).

The Government's theory also conflicts with its own previous recognition that antitrust law reaches regulatory evasion only where competition is harmed. The Government told the D.C. Circuit in the Bell System litigation that regulatory evasion through cost-shifting from a competitive market to a regulated one is not a *competitive* concern unless it also results in the threat of market power in the unregulated market: it sharply distinguished regulatory evasion "that does not afford any possibility of creating market power and that raises no competitive concern" from regulatory evasion that leads to "market power in the unregulated market" and thus raises antitrust concerns.[9] The Government does not acknowledge its change of position.

In sum, the Government's assertion of a Section 1 theory based on harm in the telephone-service market indefensibly and dangerously confuses a regulatory problem with an antitrust problem. The leading treatise, not cited by the Government, makes this point. It criticizes the Second Circuit decision for "effectively turn[ing] a claim of fraud into an antitrust claim. For example, any seller under a cost-plus contract might secretly conspire with a supplier to provide goods at inflated costs, paying a secret rebate to the seller, and with the effect of excluding alternative suppliers. As in any case of fraud or misrepresentation, the result will be that the contracted-for good is more

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[9] "Avoiding such overcharges to ratepayers in the regulated monopoly market is a regulatory concern. Under some circumstances, cross-subsidization through cost misallocation can also be a competitive concern because a firm that can recover some of the costs of its competitive operations in the rate-regulated monopoly market by including those costs in the rate base can price below cost in the competitive market without losing money. If as a result of this cross-subsidization the monopolist succeeds in driving out its competitors and preventing new entry, it may be in a position to raise its prices to the detriment of consumers in the unregulated market. Thus, by exploiting its monopoly position in the regulated market to gain market power in the unregulated market, it may earn supracompetitive profits that regulatory constraints prevent it from earning in the market in which it has a monopoly." U.S. Br. 29, *United States v. Western Elec. Co.*, No. 87-5388 (D.C. Cir. Apr. 17, 1989).

costly and consumers are injured. But no antitrust violation is apparent unless this activity threatens monopoly in a properly defined relevant market." P. Areeda & H. Hovenkamp, *supra*, at 727.

Section 2 Conspiracy. The conspiracy-to-monopolize claim is a concerted-action Section 1 claim in a different guise and cannot succeed if, as here, there is no sustainable Section 1 claim. *See* Pet. 14 n.7. The Government does not dispute this nexus; nor, conspicuously, does it defend the Section 2 holding in this case. SG Br. 17-18. The decision concededly rests on the premise that Discon alleged "that petitioners intended to assist *AT&T* in securing monopoly power in the removal services market" (*id.* at 18 (emphasis added)), a theory made up by the Second Circuit after rejecting Discon's actual theory—that the conspiracy was to make a monopolist out of *NYNEX*, which was not even a seller in the market (Discon C.A. Br. 27; Discon C.A. Reply Br. 7). *See* Pet. App. 13a-14a. But the Government neither cites any precedent for nor defends the premise that the Section 2 conspiracy claim can rest on a theory that NYNEX conspired to give AT&T, a separate company, monopoly power over NYNEX itself as a buyer in the removal-services market, the very notion held to justify dismissal as "inherently implausible" and "preposterous" in *Car Carriers*, 745 F.2d at 1109, 1110. The Section 2 holding here should be reviewed along with the Section 1 holding to ensure that the same harms are not effected through an alternative route.

CONCLUSION

The Second Circuit's ruling warrants review and reversal. The Government has advanced no sound basis for defending or ignoring the court's actual grounds of decision. The Government's alternative theories—offered in partial support of the judgment—only add to the need for review, for, in disregard of compelling contrary authority, these radical new theories would harmfully extend the power of antitrust enforcement to intrude into the regulatory sphere. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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